UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEVADA
LAS VEGAS, NEVADA

In re: USA COMMERCIAL MORTGAGE COMPANY, Debtor.	OCTOBER 19, 2006 E-Filed: 11/30/06 Case No. BK-S-06-10725-LBR Chapter 11
USA COMMERCIAL MORTGAGE COMPANY, Plaintiff, vs. WELLS FARGO BANK, N.A., et al., Defendants.	Adversary No. 06-01146-LBR
USA COMMERCIAL MORTGAGE COMPANY, Plaintiff, vs. ROBERT J. KEHL, et al., Defendants.	Adversary No. 06-01167-LBR
USA COMMERCIAL MORTGAGE COMPANY, Plaintiff, vs. STANDARD PROPERTY DEVELOPMENT, LLC, Defendant.	Adversary No. 06-01179-LBR

PARTIAL TRANSCRIPT OF PROCEEDINGS
OF
(06-01146) SCHEDULING CONFERENCE RE: COMPLAINT UNDER 11, USC, SECTIONS 105, 362, 542, 549, AND 550, NO. 38
AND
(06-01167) MOTION FOR SUMMARY JUDGMENT AND FOR ORDER DIRECTING RELEASE OF FUNDS, NO. 97

Proceedings recorded by electronic sound recording; transcript produced by transcription service.

MOTION FOR SUMMARY JUDGMENT
AND FOR ORDER DIRECTING RELEASE OF FUNDS, NO. 133
AND
MOTION FOR SUMMARY JUDGMENT
AND FOR ORDER DIRECTING RELEASE OF FUNDS, NO. 148
AND
MOTION FOR SUMMARY JUDGMENT
AND FOR ORDER DIRECTING RELEASE OF FUNDS, NO. 157
AND
STATUS HEARING
RE: EMERGENCY MOTION FOR ORDER EXTENDING
THE DEBTOR'S EXCLUSIVE PERIOD TO FILE A PLAN
TO SEPTEMBER 15, 2006, NO. 1274
AND
MOTION FOR RELIEF FROM STAY, NO. 1159
AND
(06-10725) ORDER SHORTENING TIME
RE: MOTION TO EXTEND EXCLUSIVITY PERIOD
TO CONFIRM PLANS OF REORGANIZATION
TO DECEMBER 31, 2006, NO. 1357
AND
OBJECTION TO CLAIM 26 OF PROSPECT HIGH INCOME FUND, ET AL.,
IN THE AMOUNT OF 20,000,000, NO. 1345
AND
ORDER SHORTENING TIME
RE: MOTION FOR ORDER SCHEDULING AN AUCTION
FOR THE SALE OF CERTAIN ASSETS,
APPOINTING SPCP GROUP, LLC, AS LEAD BIDDER,
AND APPROVING BID PROCEDURES AND PROTECTIONS, NO. 1381
AND
(06-01179) MOTION FOR PRELIMINARY INJUNCTION, NO. 20
AND
ORDER SHORTENING TIME
RE: MOTION FOR ORDER APPROVING RETENTION PLAN
OF DEBTOR'S REMAINING EMPLOYEES, NO. 1459
AND
(06-01167) MOTION FOR SUMMARY JUDGMENT
AND FOR ORDER DIRECTING RELEASE OF FUNDS
WITH CERTIFICATE OF SERVICE, NO. 125
AND
MOTION FOR SUMMARY JUDGMENT
AND FOR ORDER DIRECTING RELEASE OF FUNDS
WITH CERTIFICATE OF SERVICE, NO. 128
AND
FIRST INTERIM APPLICATION
OF THE OFFICIAL COMMITTEE OF HOLDERS
OF EXECUTORY CONTRACT RIGHTS
THROUGH USA COMMERCIAL MORTGAGE COMPANY
FOR REIMBURSEMENT OF EXPENSES OF COMMITTEE MEMBERS, NO. 1370

VOLUME 3
BEFORE THE HONORABLE LINDA B. RIEGLE
UNITED STATES BANKRUPTCY JUDGE

Thursday, October 19, 2006

9:00 a.m.

Court Recorder: Cathy Shim

Proceedings recorded by electronic sound recording; transcript produced by transcription service.

APPEARANCES:

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For Wells Fargo Bank, N.A.:	JEFFREY R. HALL, ESQ. Shea & Carlyon, Ltd. 233 South Fourth Street Suite 200 Las Vegas, Nevada 89101
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APPEARANCES (Cont.)

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(Court previously convened at 09:09:29 a.m.)

(Partial transcript at 12:41:38 p.m.)

THE CLERK: Bankruptcy court is now in session.

THE COURT: Be seated. Okay.

Oh, I had forgotten to mention before -- and if you'd pass this word along -- on the 30th, we won't start until about 10:30. I had to put a motion calendar on before that. So as a practical matter, it will be about 10:30 before we start.

MR. SCHWARTZER: We'll put it on the Web site, your Honor.

THE COURT: Okay. That would be great. Thanks. All right.

On the objection to claim.

(Colloquy not on the record.)

MS. CARLYON: Your Honor, I just wanted -- this is Candace Carlyon on behalf of the Investor Committee for the First Trust Deed Fund.

I just wanted to make sure the Court is aware that our objection to this same claim which was set for a hearing on the 30th has been resolved. That claim was withdrawn as to First Trust Deed Fund.

THE COURT: Okay.

MS. CARLYON: I just wanted to give you the heads-up. The paperwork was filed some time ago, but I

wanted to make sure --

THE COURT: Okay.

MS. CARLYON: -- that you were aware.

THE COURT: All right.

MS. CARLYON: Thank you, your Honor.

THE COURT: Thank you.

MS. CUNNINGHAM: We probably need to make our appearances since we --

THE COURT: Yeah.

MS. CUNNINGHAM: We didn't do it --

THE COURT: All right.

MS. CUNNINGHAM: -- this morning.

THE COURT: Go ahead.

(Colloquy not on the record.)

MS. CUNNINGHAM: CiCi Cunningham on behalf of Highland Capital and also Paul Lackey and Ross Mortillaro who are going to be arguing the motion.

MR. OLSON: Good afternoon, your Honor. Bob Olson of Beckley Singleton on behalf of the Diversified Trust Deed Fund Equity Security (indiscernible).

THE COURT: Okay.

MR. OLSON: Your Honor, the briefs on this are fairly lengthy, and I thought I would ask you if you had any specific questions you would like me to address before I start with the argument.

THE COURT: No. I really don't. They were well-done on both parts.

MR. OLSON: Okay. Well, your Honor, if I could --

THE COURT: If there's anything that you want to highlight, that would be fine. I'll have it just on both sides I think, probably.

MR. OLSON: Okay. Thank you.

THE COURT: You were surprised about the answer. I saw that. Okay. Now what do I do.

MR. OLSON: Well, I actually have several pages of notes. I thought I'd try to save everybody some time.

THE COURT: Yeah. And I appreciate that. I --

MR. OLSON: Your Honor, if I could summarize the Highland Funds claim in one sentence, it's this. They allege that the debtors owe it or the Highland Funds $20,000,000 because Diversified loaned 11-and-a-half-million dollars to Epic Resorts. We loaned somebody money. And because of that, we owe Highland Funds twice as much money.

The legal theory that all this is predicated upon is that Diversified tortiously interfered with Epic Resorts' $130,000,000 indenture.

The facts are pretty straightforward, and the whole basis of this claim objection is is that this issue has been tried by Highland Funds acting through their indenture trustee in the Epic bankruptcy. It was lost. It was

appealed, and it was lost on appeal.

Your Honor, we submit that the claim should be disallowed. Highland Funds have had enough bites at the apple in this case.

The facts -- and I believe they're pretty much undisputed -- can be summarized as follows: On July 8, 1998, Epic Resorts issued $130,000,000 of bonds. Of those $130,000,000 of bonds, the Highland Funds later purchased in excess of 90,000,000 of those bonds.

I discovered looking through the appellee's brief on appeal in the Epic bankruptcy that most of those bonds were purchased by the Highland Funds after Diversified made the loan that gives rise to this claim, not before.

The argument is is that although this indenture was dated July 8, 1998, in June of 2000, approximately two years later, Epic borrowed 11-and-a-half-million dollars from Diversified.

And I think Epic is -- or excuse me. Highland Funds are maintaining that there were three provisions of the indenture that Diversified knowingly interfered with when it loaned the money to Epic.

The first is is that the Epic Marquis which was a subsidiary of Epic Resorts was supposed to obtain Bureau of Indian Affair approval to grant the indenture trustee a leasehold deed of trust against property that I believe was

located on an Indian reservation. Your Honor, that approval was never obtained.

The indenture trustee did nothing between 1998 and 2000 to perfect any lien against that leasehold interest. It was just simply something that did not happen.

The second covenant in the indenture that the Highland Funds claim Diversified tortiously interfered with was the prohibition upon Epic incurring any additional debt. In other words, Epic covenanted not to borrow any additional funds. The third negative covenant was that Epic was prohibited from further encumbering any of its assets.

Your Honor, approximately, a year after Diversified loaned the 11-and-a-half-million dollars to Epic, the Highland Funds engaged counsel and filed bankruptcy petitions against Epic Resorts and then later against the subsidiaries of Epic Resorts, including the Epic Palm Springs entity.

On April 23rd, 2002, the Bank of New York who was the successor trustee under the indenture filed a lawsuit against Epic Palm Springs and against Diversified. That lawsuit contained two claims for relief.

The first claim for relief in the lawsuit was to establish an equitable lien against the property that was senior to that held by Diversified. The second claim for relief was to equitably subordinate the claim of Diversified

in the Epic bankruptcy.

Your Honor, there was a lot of discovery that was conducted in that case and that Epic -- or excuse me -- that Highland Funds had submitted in connection with their opposition in this case.

They took the deposition of Mr. Milanowski and inquired of him whether or not they knew of the indenture knowingly violated, et cetera. That deposition transcript was produced by Highland Funds.

Similarly, they had deposed Mr. Hantges, made similar inquiries of him. They also deposed Thomas Rondall (phonetic), the attorney for Diversified, and made similar inquiries of him.

In the Epic bankruptcy court, the bankruptcy court conducted a joint evidentiary hearing on the complaint that sought equitable subordination and the imposition of an equitable lien with Diversified's motion for relief from the automatic stay.

In connection with that hearing, the Bank of New York briefed the tortious-interference issues and alleged that Diversified tortiously interfered with the indenture.

And because of that tortious interference, the equitable lien should be imposed, and the claim of Diversified should be equitably subordinated.

The bankruptcy court considered that, held at least two

days of evidentiary hearings, portions of the transcripts of which the Highland Funds have submitted in opposition to the claim objection, and found that there was no tortious interference.

And the Epic bankruptcy court did that in a published opinion, and I'd like to read briefly from that published opinion, your Honor.

I'm referring to it looks like pages 524 and 525 of what I've called Epic I in the papers, 290 Bankruptcy Reporter.

THE COURT: Okay.

MR. OLSON: The Court states, "While USA Capital" --

THE COURT: 524.

MR. OLSON: Yes.

THE COURT: Yes.

MR. OLSON: The Westlaw printout --

THE COURT: I see it.

MR. OLSON: -- I have --

THE COURT: I see it.

MR. OLSON: -- is on page 11.

THE COURT: Yes. I see it.

MR. OLSON: They state, "While USA Capital has admitted that it read the indenture and the prospectus prior to approving the loan to Epic Palm Springs, the Court does

not find this sufficient to rise to the level of egregious conduct. Further, we cannot conclude that USA Capital tortiously interfered with the agreement between BNY and Resorts."

If you go down to the next paragraph, your Honor, it states, quote, "There is no evidence of purposeful action on the part of USA Capital to harm the relationship between Resorts, Capital, and BNY. Epic Palm Springs advised USA Capital that no other creditor held a lien on this lease.

Although USA Capital had knowledge of the restrictive covenant, Epic Palm Springs represented and warranted that the entry into the secured-loan transaction with USA Capital did not and will not result in a breach or constitute a default under or require any consent under any indenture," close quote.

The Court then went on to say, "In addition, USA Capital's report did not reveal any other liens on this lease.

Prior to consummating the transaction, USA Capital confirmed with the BIA that no other liens existed on the property.

USA Capital's actions were not intended to harm the relationship between BNY and Resorts. Furthermore, the relationship between Resorts, Capital, and BNY was not altered.

BNY did not have a lien on the leasehold prior to USA Capital's loan to Epic Palm Springs and did not have one after the loan."

Your Honor, BNY was dissatisfied with that decision and appealed to the district court, and I think it is crystal clear that the tortious-interference issue was litigated on appeal by Bank of New York.

For instance, if you look at the appellate brief that was filed by Bank of New York in the appeal -- I believe, your Honor, I submitted that as Exhibit -- bear with me for a moment -- Exhibit 9.

When you go to page 2 of that, the third full paragraph states, quote, "Finally, BNY can demonstrate that USA Capital tortiously interfered with its contractual relations with the debtors.

Such wrongful conduct of USA Capital was further support for the equitable subordination of USA Capital's claim."

Your Honor, they went on to brief the issue. The district court in what I have called Epic II clearly pointed out that tortious interference was being litigated and considered on appeal.

For example, in Epic II which is 307 Bankruptcy Reporter, your Honor -- I'm looking at page 770. It's page 4 on my Westlaw printout -- the Court stated, quote --

and the Court stated when describing BNY's or BNY's issues on appeal that BNY alleged this.

Quote, "And that the bankruptcy court should have found that USA Capital's conduct was purposeful and constituted tortious interference with the contractual rights of BNY," close quote.

In the next paragraph -- and I'm reading from the middle of it just at the very tail end of page 770, your Honor -- the Court stated, quote, "USA Capital further contends that the bankruptcy court correctly rejected BNY's argument that USA Capital acted in bad faith and tortiously interfered with the indenture," close quote, so it's clear that issue was considered on appeal.

And on page 772 of that decision, the Court affirmed the bankruptcy court by stating, quote, "The bankruptcy court thoroughly analyzed the facts of this case and found that despite USA Capital's actual knowledge of the restrictive covenants in the indenture USA Capital did not intend to harm any relationship between the debtors and the bondholders and its conduct did not rise to the level required to equitably subordinate the claim of a noninsider," close quote, so I think it's crystal clear that this was litigated in Delaware.

Now, I want to talk about the relationship between the Highland Funds and BNY very briefly. BNY was the successor

trustee under the indenture.

The Highland Funds owned in excess of $90,000,000 of the $130,000,000 of bonds issued under that indenture, and I think this is a very key point that the Highland Funds are trying to de-emphasize.

Highland Funds and Bank of New York had the same counsel in the Epic bankruptcy. They filed a Rule 2019 statement saying they had the same counsel.

If you look at the papers that were filed in the Epic bankruptcy, they admit to it at several different instances, for example, in their opposition to the motion for summary judgment. It's clear they have the same counsel. They had input in what was going on in Delaware.

Your Honor, shortly after the BNY adversarial proceeding was filed in Delaware, approximately three months later, on July 11, 2002, the Highland Funds in their capacity as bondholders and not through the indenture trustee filed the complaint in Nevada.

And the complaint in Nevada was filed against Diversified and the attorney that delivered an opinion letter, and that complaint basically sought damages for tortious interference because Diversified made the 11-and-a-half-million-dollar loan to Epic.

It arose from the same identical facts, the same transaction. I mean, there is no way to distinguish the

facts in the Nevada action from the facts in the Delaware action.

They also sought relief against Diversified on two derivative claims, the conspiracy and the aiding-and-abetting claim.

Your Honor, during that case, the parties caused it to be stayed pending the outcome of the Epic litigation in Delaware.

After the Epic litigation was resolved, Diversified filed a motion for summary judgment which was denied. Diversified filed the motion for summary judgment on the sole ground that the doctrine of issue preclusion or collateral estoppel barred this action.

And I think this is really crucial because they did not address or allege that the action was barred under the doctrine of res judicata or claim preclusion, and those are different legal concepts. They have different ramifications.

Before I get into the bulk of the argument, I wanted to point out that the Nevada order denying the summary-judgment motion was never reduced to a written order. It's in the form of a minute order.

The Nevada Supreme Court has held in cases that I've cited in the reply indicating that minute orders are of no force and effect.

And even if an order had been entered, your Honor, it would be interlocutory. It couldn't be appealed. It is not final, and it could be reconsidered at any time by whatever judge is trying the case.

So I don't think that it really has any precedential effect in this case. It clearly is -- well, I think it's irrelevant, but I wanted to address that.

The key issue that I think was raised in state court and that has been raised in Highland Funds' opposition is basically this.

That claim preclusion -- or excuse me. Issue preclusion or collateral estoppel didn't apply because the Delaware Court applied a different standard of proof or burden of proof, and that is the egregious-conduct standard.

Your Honor, I have found the concept of an egregious-conduct standard as a burden of proof kind of confusing.

I had always thought burdens of proof were things like clear-and-convincing evidence, by a preponderance of the evidence, beyond a reasonable doubt.

I had never heard of an egregious-conduct burden of proof. I can see how a party would have the burden of proving that, but I don't think there is such a burden of proof.

Your Honor, every case that I was able to locate

addressing the burden of proof in tortious-interference claims, have allegations of fraud, have held that the burden of proof is by the preponderance of the evidence, and I have cited -- I don't know -- 20, 30, 40 cases to that effect, and I'm sure there were a lot more.

I think the burden of proof is by a preponderance of the evidence, and I think that burden of proof is what the U.S. Supreme Court would apply per the Groven versus Garno (phonetic) decision.

Your Honor, with respect to res judicata or claim preclusion, again, I don't think that was litigated in state court.

It doesn't appear to me to be briefed in the opposition that the Highland Funds filed. I think they focussed on collateral estoppel or issue preclusion.

But the elements for res judicata to apply are pretty simple. First is there has to be a final ruling on the merits. Second, the ruling has to be against a party to that proceeding or somebody that's in privity with that party. Third, there has to be a subsequent suit based upon the same action.

Now, the commentary in the case law interpreting the third element of taking it a step further, basically, res judicata bars a party from litigating a claim that was or could have been litigated in the prior action.

Now, I think this is crucial because in the prior action they called their claims equitable subordination, and they cite an equitable lien, but it was all predicated upon allegations of tortious interference. They could have. They should have raised that claim in that action.

But if you apply these three elements of res judicata to the facts in this case, I think it's clear the claims should be disallowed.

First, there is no doubt that there was a final decision in Delaware, no doubt whatsoever. Second, we maintain that an indenture trustee is in privity with the bondholders it represents when it sues to collect funds owed under an indenture.

The first basis for supporting that allegation, your Honor, is what I have called contractual privity. I don't know if there's an actual legal concept called that, but I think the indenture contractually places the Highland Funds in privity with Bank of New York.

And if you look at the reply that I filed, your Honor, on page 11 -- or excuse me -- page 13, you will see the language from Section 1105 of the indenture that gave Bank of New York this right to pursue actions on behalf of the bondholders.

THE COURT: Um-h'm.

MR. OLSON: Okay.

THE COURT: Go ahead.

MR. OLSON: And what I'll do is just read into the record the language that I've highlighted. "The trustee may on behalf of the security holders take all actions it deems necessary or appropriate in order to, A, enforce any of the terms of the collateral documents and, B, collect and receive any and all amounts available in respect of the obligations of the subsidiary guarantors hereunder.

The trustee shall have power to institute and maintain such suits and proceedings as the trustee may deem expedient to preserve or protect its interests and the interests of the security holders of the collateral."

Your Honor, that provision empowered Bank of New York to go out and take acts on behalf of and for the benefit of the Highland Funds. I don't think you could have a clearer example of privity.

Interestingly, in the City of Seattle case that's cited in the papers, if you look at that case, and you look at the language that was involved in I think it was actually Section 1104 and 1105 of the indenture in that case, the Court held that that vested the indenture trustee in that case with authority to enter into a settlement that was binding on all the bondholders and commented that if it weren't binding on the bondholders or the actions of the trustee weren't binding on the bondholders it would lead to

an incongruous result.

Second, your Honor, I've spent a lot of time researching the available case law that addresses the issue of whether an indenture trustee is in privity with bondholders.

And what I found and cited in the materials are two cases from the Ninth Circuit Court of Appeals that answer that question affirmatively, the City of Seattle case and the Stratosphere case.

I cite a number of U.S. Supreme Court cases, some in the main body of the argument, some in footnotes. One of those cases, your Honor, you will note was from 1876 that held that the trustee in a railroad indenture acted on behalf of and bound the bondholders on that indenture. That's been the law of this country for at least 130 years.

I will note that in the opposition I did not see a single case saying that an indenture trustee cannot bind the bondholders when it sues on their behalf. I have not seen a single case that says there's no privity, and there is nothing in their papers to that effect.

Additionally, your Honor, all the treatises such as Fletcher Cyclopedias on corporations, they say the same thing. Bondholders are bound by the acts of the indenture trustee.

And, finally, your Honor, there is admissions in the

papers filed before this Court and in Delaware that there was privity. They admit certain facts that I think establish privity.

For example -- and I'm looking at page 3 in my reply that cites various -- excuse me -- page 4 of my reply that cites various portions of the opposition that Highland Funds filed in this case.

They state, quote, "The bond trustee on behalf of the bondholders declared that an event of default existed under the indenture and accelerated the entire amount due and owing under the indenture and the bonds."

When they go on to describe the litigation in Delaware, they state, "The Highland Funds concede that the district court affirmed the bankruptcy court's finding that the indenture trustee and, therefore, the Highland Funds do not have a property interest in the property, and that the conduct of Diversified was not sufficiently sufficient to warrant equitable subordination."

There are similar allegations in the other papers that I have cited where Bank of New York said it was acting on behalf of the bondholders.

Your Honor, the third element for the application of res judicata is is that the complaint and the claims arise from the same set of facts. There is no dispute about that.

The BNY adversary complaint and the Nevada complaint

were both predicated upon the same allegations of tortious interference by Diversified.

For those reasons, I think the claim should be disallowed in its entirety under the principle of collateral -- or excuse me -- res judicata.

Your Honor, collateral estoppel I think also bars the claim. The elements for that is that you have to have the identical issue decided in a prior action. There has to be a final judgment on the merits.

The party that the estoppel is being asserted against has to be a party to the case in the prior action or in privity with them, and there has to have been a full and fair opportunity to litigate it. Your Honor, I think all four of those elements are present in this case.

Tortious interference was painstakingly detailed by the Court in Epic I. They considered tortious interference. If you compare the elements the Epic I Court examined with the elements in Nevada, you will find that they're the same.

Second, there is no doubt it was a final judgment on the merits. Third, the Highland Funds were in privity with Bank of New York. They even had the same counsel, your Honor.

And, fourth, it was fully litigated. There was discovery. There was a trial. There was a briefed appeal, and there was at least a published decision by the district

court, so I think that it had to have -- there is no way it can be found not to have been fully and fairly litigated.

With that in mind, your Honor, we would request that the claim be disallowed in its entirety and, hopefully, put the equity security holders to the Diversified Fund in a position to where they can start receiving distributions.

THE COURT: Okay.

MR. OLSON: Thank you.

MS. CARLYON: I'm sorry to interrupt --

THE COURT: What --

MS. CARLYON: -- your Honor. I didn't want to detract from Mr. Olson's excellent argument. But having entered my appearance, I wanted to get permission to be excused.

THE COURT: Oh, sure. Thank you.

MS. CARLYON: Thank you, your Honor.

THE COURT: Also, if there's anybody left on the phone, we probably don't need to leave them on the phone. I don't want to cut anybody off, but I don't want to incur the cost of having the phone line open, either. What do you think? Go ahead? It doesn't take --

MR. SCHWARTZER: This is --

THE COURT: -- that much more?

MR. SCHWARTZER: -- in the claims litigation in the main case, your Honor. I guess --

THE COURT: It's in --

MR. SCHWARTZER: -- they would have it --

THE COURT: -- the fund, so, all right, we'll leave it open. I mean, it's in the one main case.

MR. SCHWARTZER: On behalf of the debtor of USA Capital Diversified Fund, we filed a very simple joinder, your Honor, and I'm not going to repeat Mr. Olson's argument.

I think he went over almost everything I would have said, other than I would want to point out despite whatever happened in state court on the motions for summary judgment those are not final judgments. They're not binding in any way on this Court and not to have no opinion about what the judges did there.

But it does appear to me that in addition to res judicata collateral estoppel does apply with regard to this because there does seem to be the identical underlying facts were presented to the Delaware Court.

The Court specifically found there was no tortious interference. It's clearly a final judgment on the merits. The privity issue was the same.

The bondholders -- an indenture trustee as a representative of a bondholder is usually held just on that facts alone to be privity.

And the last thing is the opportunity to litigate, and

here you have the Highland Funds as a group being the majority bondholders being represented by the indenture trustee having the same counsel in the case. They had the opportunity.

It's, you know, there was -- remember, this case in Delaware arose on a motion to lift stay filed by Diversified.

Therefore, Highland Funds would have the opportunity on its own behalf to litigate and oppose that motion to lift stay if it chose to do so.

The fact that they chose to do it through the Bank of New York as the indenture trustee doesn't mean they did not have the full and fair opportunity to litigate the issue, and we would think on that additional basis, your Honor, the claim should be dismissed.

THE COURT: Okay. Mr. Krieger, we're not going to start the Chapter 13s 'til 2:30.

The trustee knows that, too, right? Oh, we don't know.

THE CLERK: Yes, they do.

THE COURT: Yeah.

MR. SCHWARTZER: Yeah. You do have two calendars I think.

THE COURT: Oh, I know. I've got three calendars.

MR. SCHWARTZER: I know because I have -- I have one (indiscernible) two other (indiscernible) in my car.

THE COURT: So, I mean, you're welcome to stay. But, you know, if you've got better things to do, we aren't going to start there 'til 2:30, so --

MR. KRIEGER: Okay. (Indiscernible) stay (indiscernible).

THE COURT: All right. Opposition.

MR. LACKEY: Good afternoon, your Honor. My name's Paul Lackey from the law firm of Lackey Hershman, and I represent -- people have kind of been calling it the Highland Funds. I want to take a step back, so you understand exactly who it is I represent.

But it's Prospect High Income Fund, it's ML CBO, it's PamCo Funding, Pam Capital, Highlander Crusader, and PCMG Trading, and what are these funds?

Well, these are investment funds, and they're large investment funds, and what they do is they take money from people that are investing it and invest that money for them.

For example, some of their largest investors include the teachers union, the California Teachers Union Retirement Funds, and they invest people's retirement funds in various ways, so they can make money.

And in this case, they were these various -- I'll call them Highland Funds now -- were bondholders in a company called Epic Resorts.

And I'll try not to be too repetitive because I think

many of the basic facts are not in dispute, but they were bondholders in a company called Epic Resorts which was a timeshare company that was in bankruptcy in Delaware.

Of course, when Epic Resorts issued the bonds, there was a bond indenture, and that bond indenture had three requirements set out, previously, by counsel.

They agreed not to further encumber this Palm Springs property, the Epic Marquis, they agreed not to incur additional debt, and Epic Resorts agreed to use their best efforts to get a lien on this property for the benefit of the bondholders.

In early 2000, USA Capital or Diversified -- I've been calling it USA Capital for a couple of years in the litigation in state court, but I'll try to refer to them as Diversified -- and Epic entered into discussions whereby Diversified was to loan money to Epic. As part of that loan agreement, Diversified wanted a lien on this Palm Springs property, the Palm Springs Marquis.

Diversified asked for and received, actually received, a copy of the indenture. Now, after they reviewed the indenture, they were rightly uncomfortable with the terms of the loan.

And they went back to Epic and said, hey, it looks like your indenture doesn't allow this kind of a loan. What's the problem? Epic says, well, we'll get you an opinion

letter.

They didn't timely receive an opinion letter. However, because of the amount of money involved and the generous terms of the loan, Diversified went ahead and funded the first half of the loan without even receiving an opinion letter that it didn't violate the indenture.

Now, thereafter, (indiscernible) on the bankruptcy opinion, Diversified did receive an opinion letter from an attorney, Defendant Burke (phonetic), and funded the remainder of the loan.

Subsequently, Epic Resorts failed to make a bond payment to my bondholders when it was due which resulted in Epic being placed in an involuntary bankruptcy in Delaware, later converted into a voluntary bankruptcy.

During the bankruptcy for the first time, the bondholders discovered that they didn't have a perfected security interest on the Palm Springs property, and that, in fact, Diversified claimed to have such an interest.

Now, in the bankruptcy proceeding, Bank of New York as indenture trustee brought an adversary proceeding that sought only two things.

The first was that an equitable lien on the property. Now, everyone agrees that's not really in play in today's argument.

The second is to have Diversified's debt equitably

subordinated to the bondholders. That was the nature of the proceeding.

The bankruptcy court in the opinion that you've been discussing and looking at denied that request. In its opinion regarding equitable subordination, the bankruptcy court noted that it used the standard of egregious conduct because equitable subordination was a, quote, "extraordinary remedy." And on that basis, the Court denied the motion for equitable subordination. Now, that was appealed.

And on appeal, the appeal brief said you used the wrong standard. The bankruptcy court didn't need to find egregious conduct to get to equitable subordination.

If she had found mere tortious interference or one of these other torts regardless of whether it was egregious, that should be enough to get equitable subordination.

And the district court makes it crystal clear that that's not the case. That the case in equitable subordination is that you have to have egregious conduct.

And as a matter of fact, the very sentence read to you by Mr. Olson from the district court opinion makes it clear that the bankruptcy court found its -- its being Diversified's -- conduct did not rise to the level required to equitably subordinate the claim of an noninsider. And in the paragraph before that, the district court makes it clear that that standard is egregious conduct.

And so if you weren't clear from the bankruptcy court opinion -- although I think it's relatively clear that she says you have to have exceptional remedy, egregious conduct, and then it reached the level of egregious conduct -- the district court opinion says everything below was correct with regard to egregious conduct, and you have a correctly-applied heightened standard of review to BNY's claim.

That standard, your Honor, is not the standard for determining tortious interference under Nevada or any other state. It is simply the standard for determining equitable subordination.

Defendant Diversified now seeks for about the third time to avoid liability here by using this opinion to avoid the liability to the bondholders of Epic. And, of course, they argue claim preclusion and issue preclusion, primarily.

Now, Diversified has lost this exact same argument in front of --

THE COURT: So what?

MR. LACKEY: -- two judges. Well, I'm not saying --

THE COURT: So what?

MR. LACKEY: -- it has a preclusive effect, but I suspect --

THE COURT: Don't --

MR. LACKEY: -- had they won the argument --
THE COURT: -- argue it, then. Don't make a big deal out of something --
MR. LACKEY: I thought it was something --
THE COURT: -- that has no --
MR. LACKEY: -- that you would like to know.
THE COURT: -- legal authority.
MR. LACKEY: That --
THE COURT: You try to make a big deal --
MR. LACKEY: I --
THE COURT: -- out of the fact --
MR. LACKEY: I don't think it's a --
THE COURT: -- they didn't tell you this. They didn't tell you that. There is no legal effect to that, right?
MR. LACKEY: There is no legal effect on this proceeding today.
THE COURT: All right. Then move on.
MR. LACKEY: But I think it's an important factual --
THE COURT: Why?
MR. LACKEY: -- piece of the factual background --
THE COURT: Why?
MR. LACKEY: -- that they've lost this argument. If I were a judge, your Honor, it's something I would want

to know whether or not it's -- it's not a binding argument.

THE COURT: Well, then don't make it --

MR. LACKEY: But I think it's important.

THE COURT: -- if it hasn't got any legal effect.

MR. LACKEY: Okay, your Honor.

THE COURT: I mean, you purport to argue that in your pleading. You just don't put it as a fact. You purport to have it and then just leave it --

MR. LACKEY: Well --

THE COURT: -- making me have to go and think, well, are you trying to argue something.

MR. LACKEY: No. We would have told you if we were arguing that it was meant to be binding. It's part of the factual background of how this case gets to you and how far along the case has come and been in state court.

I'm going to address their individual arguments now, your Honor, but I also think it's important to note that we filed a motion to lift stay on October 18th, a couple of days ago or maybe yesterday at this point, to allow us to finish this litigation in the state court.

THE COURT: This is from your summary of arguments. "First, the preclusion issues have already been decided in Highland Funds' favor in the Nevada State Court."

MR. LACKEY: Correct, your Honor.

THE COURT: You've got that in your argument

authority --

MR. LACKEY: Right.

THE COURT: -- not your factual authority.

MR. LACKEY: Okay. Then, perhaps, that it's misplaced, but I think that it's an important point.

THE COURT: You were trying to mislead me.

MR. LACKEY: Not at all, your Honor. We were trying to show you exactly what had happened before. No one's argued, well, it's not -- there's not an argument or a case citation that it somehow has a preclusive claim-estoppel or issue-estoppel effect.

The burden on claim preclusion or issue preclusion is, of course, on Mr. Olson and his clients, on Diversified, to prove with clarity and certainty -- and that's the Hydranautics opinion in the Ninth Circuit, 2000, cited in our brief -- that these issues create claim or issue preclusion, and the dispositive issues were simply not cited or not previously decided.

The Delaware bankruptcy complaint in the portions cited are about equitable subordination, an extraordinary remedy that requires egregious conduct.

The district court then held that it was precisely that egregious conduct which warrants equitable subordination and which was not found. That issue has no bearing on these issues today.

The issues here are whether certain provisions of the indenture providing additional encumbrance of debt and provision of liens were violated and whether USA Capital, Diversified, intentionally assisted or participated in the violation of those provisions, not whether there was egregious conduct, and then whether their violation of the indenture resulted in damage to the Highland Funds.

Furthermore, your Honor, not only were the dispositive issues not decided under anything like the same standard you would in a state law claim, there's no res judicata effect because the tortious-interference claims between my clients, the bondholders, and Diversified were noncore claims that were state law claims between one nondebtor and another.

There is not a case cited about the preclusive effect of an equitable-subordination decision because it has no such effect in this kind of scenario where you have separate state law claims between the one-time nondebtor, Diversified, and my clients, the nondebtor, the bondholder.

This was an equitable-subordination proceeding that doesn't have that kind of res judicata effect, and none of the cases they cite have anything to do with that kind of proceeding.

The cases they cite, the Stratosphere case and the other privity case, are about releases given by a bankruptcy case, the Seattle case, releases given by a bankruptcy

court.

They have nothing to do with a proposed res judicata effect of an equitable-subordination proceeding. Since the equitable-subordination proceeding requires such a high standard, egregious conduct, to get to an extraordinary remedy, it simply doesn't have and there are no cases that indicate that it has res judicata effect.

As a matter of fact, the Third Circuit 1999 core state's case that they cite says that claim preclusion in a bankruptcy procedure will only apply if the claim is at least related to the bankruptcy case.

"A party to a bankruptcy won't be precluded from later bringing a claim that could not conceivably have any effect on the bankruptcy estate."

Furthermore, the Fifth Circuit in Howell Hydrocarbons, 897 F .2d 183, found that a bankruptcy court's confirmation plan wouldn't preclude a later RICO claim because the bankruptcy court would not have jurisdiction over the claim, the same as here.

Our nondebtor claim at the time against a nondebtor for state law violations is simply not one that the bankruptcy court could have or would have entertained as part of its equitable-subordination claim, and that leads directly to the third point which is that the issues were decided under a markedly-different standard.

It is absolutely true that the Delaware Court did state in one of the paragraphs that they could not conclude that USA Capital "tortiously interfered with the agreement between BNY and Resorts."

That was after in the previous paragraph the Court indicated it was considering this tortious interference under an egregious standard. That's the bankruptcy court opinion at pages 18 and 19.

When one looks to the district court opinion, it becomes even more clear because there the appellants argued the bankruptcy court used the wrong standard.

There is no egregious standard for equitable subordination, and the bankruptcy court says that's not true. The bankruptcy court -- or I'm sorry. The district court says that's not true.

The district court stated that USA Capital's, quote, "conduct does not rise to the level required to equitably subordinate the claim of a noninsider," close quote. And in the previous paragraph, they indicate that that is egregious conduct.

And, of course, what you can't get around is that when different standards are used collateral estoppel or res judicata simply don't apply, and those are the Ninth Circuit cases cited in our brief.

Thus, there has been no full and fair litigation of

Trust Deed Funds' conduct. Whether it's tortious interference or whether it's aiding and abetting the estate, the only issue decided by the bankruptcy court was does it reach a level that it's egregious that gets you equitable subordination.

Furthermore, your Honor, I think it's at a minimum there are some fact issues regarding privity. This is a different case than Seattle or than Stratosphere where you have an undisputed relationship between the indenture trustee and the bondholders.

Here, by 2002, the bondholders had sued the indenture trustee, had sued BNY, for its failures with regard to various things relating to the bonds, and that's a substantially-different case than any of the privity cases they cite.

I don't think the privity argument is important, ultimately, here because I don't think you have res judicata for equitable subordination or for an egregious claim.

But at a minimum, it seems like you would have to schedule an evidentiary hearing to determine the status of BNY's relationship to the bondholders given that it had already been sued for breaches of the indenture itself.

Of course, your Honor, there is sufficient evidence of tortious interference. There's the sworn testimony of the four USA Capital principals that establishes -- cited in our

brief -- that they had knowledge of the indenture, that they had an actual copy of the indenture, and that they had reviewed the indenture and were concerned about the indenture provisions prior to closing on the Epic loan.

Furthermore, your Honor, the Delaware Bankruptcy Court would have no effect on conspiracy or aiding-and-abetting claims.

These claims are not derivative of the tortious-interference claims. They contain separate elements, and they say that, in essence, Diversified assisted the estate in defrauding us, the bondholders.

And you know they defrauded the bondholders because they didn't make the bond payment, and those claims are separate and apart from the tortious interference relating to the lien which was examined in the bankruptcy court.

THE COURT: Okay. Thank you. All right.

Reply.

MR. OLSON: Bob Olson on behalf of the Diversified Committee. There are just a couple of points I'd like to respond to.

First, the allegations that a bankruptcy court somehow doesn't have jurisdiction, I think those are unfounded. The United States Supreme Court has said that when you file a proof of claim you submit to the bankruptcy court's jurisdiction.

That's the Langenkamp versus Culp decision in 1990 and the Granfinanciera decision, 1989. It's clear the bankruptcy court has jurisdiction on this.

Your Honor, with respect to the egregious-conduct standard, I think there is confusion as to it being an additional element to be shown versus the burden of proof.

If you look at the opposition that was filed -- and please allow me to grab that -- I think the opposition makes this point clear.

Page 17 of the opposition, footnote 10, your Honor, cites a Third Circuit case, Lightning Lube versus Witco Corporation, for the proposition that, quote, "Finding that tortious interference requires intentional conduct, but punitive damages are awarded only on a finding of egregious conduct." In other words, you can have a tortious interference that is egregious and one that is not.

If you find there is a tortious interference, they can look at the egregious-conduct standard to see if punitive damages are warranted.

It's basically the same thing with equitable subordination. I would submit that it's an additional element. It's not a different standard of proof.

Now, where this becomes I think crucial, your Honor, is is the bankruptcy court in Delaware examined the tortious interference, and they found there was no interference.

There was no intent to interfere.

There was no alteration of BNY's contractual rights with Epic because Diversified made the loan. They didn't have to get to whether the interference was egregious because they found there was no interference, and I think the waters have been kind of muddied on that point.

Your Honor, I think that it's clear this case has been litigated. Mr. Lackey has pointed out all the deposition testimony supporting their claim of tortious interference.

That testimony was obtained in the Epic bankruptcy in connection with the Bank of New York's lawsuit against Diversified. That's where all that discovery came from. It didn't come from the Nevada action.

For those reasons, your Honor, I would submit that this Court should simply disallow the claim in its entirety.

Thank you.

THE COURT: Okay.

MR. LACKEY: Your Honor, may I point you to one paragraph, a district court opinion, briefly --

THE COURT: All right.

MR. LACKEY: -- because it addresses that proof-of-claim argument. I believe it's on page 5. The way it paginates from Westlaw, the document in front of you, it's the second full paragraph --

THE COURT: What page?

MR. LACKEY: -- under the discussion, page 5. It says page 5 --

THE COURT: Um-h'm.

MR LACKEY: -- at the top right-hand corner.

THE COURT: Um-h'm.

MR. LACKEY: Under discussion, the second full paragraph that begins by its appeal --

THE COURT: Um-h'm.

MR. LACKEY: -- about midway down right before the citation, the district court says, "The party seeking to apply equitable subordination bears a higher burden of proof in which he or she must show that the respondent engaged in egregious conduct such as fraud, spoliation, or overreaching."

The district court specifically says that for what they're affirming which is equitable subordination there is a higher burden of proof. Those are the words of the district court.

That it is a separate burden of proof than any other kind of burden of proof that you would have in proving tortious interference or any other kind of tort claim.

MR. OLSON: May I respond briefly, your Honor?

THE COURT: Okay.

MR. OLSON: The district court does use burden-of-proof language, but there is no such thing as a

burden of proof of egregious conduct.

I think they have the burden of proving egregious conduct which is different than the underlying tortious interference, but they didn't even get that far.

THE COURT: Okay.

MR. OLSON: Thank you.

THE COURT: Mr. Schwartzer, did you want to say something?

MR. SCHWARTZER: I just want to make sure the Court saw what I think is the obvious point. In looking at page 524 of the Epic I decision, the Court specifically goes through the elements of tortious interference which are exactly the ones everybody agrees that it doesn't require egregious conduct and says, "We cannot conclude that Diversified tortiously interfered with the agreement between BNY and Epic," and then it says, "The elements of tortious interference are."

I mean, the bankruptcy court in Delaware clearly applied the standard that everybody agrees should be applied for tortious interference without a higher requirement of egregiousness.

And maybe that wasn't required to be done on the 510, you know, subordination action, but they did do it. It's a finding of fact and a conclusion of law.

And, therefore, it's clearly gone ahead on claim

preclusion, even if it's not going to work on res judicata. And if there was no tortious interference, there's no claim by the Highland Funds, end of story.

THE COURT: Okay. Well, I'm going to sustain the objection to claim. As we know, the federal law of claim preclusion applies.

And just to reiterate here, issue preclusion forecloses relitigation of factual or legal issues that have been actually and necessarily decided in earlier litigation, and the elements are a fair and full opportunity to litigate, issue actually litigated, final judgment, and privity.

Well, despite the arguments, the point is that tortious interference is a subset which would entitle one to equitable subordination.

So in determining whether or not there was equitable subordination that was necessary, the Court looked at, well, what are you arguing was the conduct that creates equitable subordination. What was the egregious conduct you're arguing?

Highland and BNY says, wait a minute, it's tortious interference. Let us tell you all about tortious interference.

And the bankruptcy court in Delaware disagreed and said as Mr. Schwartzer indicated at page 290 B.R. 524 right at headnote 13, "Further, we cannot conclude that USA Capital

tortiously interfered with the agreement between BNY and Resorts. The elements of tortious interference of a business relationship are as follows," and it went on to list the elements.

There is no evidence of purposeful action to harm. Epic advised USA Capital that no other creditor held a lien. Although USA had knowledge of the restrictive covenants, Epic Palm represented and warranted the entry will not result in a breach.

In addition, USA Capital's report did not reveal any other liens. Prior to consummating, they confirmed no other lien. USA Capital's actions were not intended to harm any relationship.

Furthermore, the relationship was not altered. BNY did not have a lien on the leasehold prior, and it did not have one afterwards.

So in order to determine as I've indicated whether or not equitable subordination's appropriate, the Court looked at tortious interference as invited to by Highland. That actual issue has been litigated.

But even if you go and say, well, what was the actual issue because we have the state court issues, I think we also have claim preclusion because that bars an action which involves the same cause of action.

When you look at cause of action, you look at -- it's a

transactional approach, whether the two suits arise out of the same transactional nucleus of facts, and a contract is considered to be a transaction for claim-preclusion purposes.

Again, here in order -- it's the same set of facts. And here in the state court -- and I'm a little concerned about things that are being told to me that don't match the pleadings.

Counsel told me that, well, we've got some other claims of action that aren't just tortious interference. Well, the second claim of action is conspiracy to commit tortious interference.

You can't have a conspiracy to commit something that's already been litigated. Tortious interference was the gravamen of the complaint.

Then you also tell me that aiding and abetting was separate. Burke -- oh, I'm sorry. That says Burke. "Burke knowingly and substantially assisted USA Capital in substantially interfering.

USA Capital knowingly encouraged Epic to breach the duties and obligations (indiscernible) the plaintiffs." It doesn't even use the words "aiding" and "abetting" as against USA Capital.

So I find that issue preclusion and/or claim preclusion -- oh, let me talk about privity. I just am

amazed that you argue that you're not in privity with the trust indenture.

That would just turn trust-indenture law upside down, how in the world you could say that a person who holds a bond isn't bound by the trust indenture.

What's amazing to me is, Highland, I assume that you have all these claims. I can't envision that you would suggest that any one of the people that invest in your fund are free to go out and sue on something after you've already litigated the issue.

Or, for example, you've won a claim on behalf of your investors against someone. Let's say Diversified under your theory, and let's assume I guess Diversified, and you lose, and somebody brings it that they couldn't argue res judicata.

I mean, I'm just amazed that you could make such an argument, and I'm just amazed that there wasn't an 9011 pleading brought on that particular ground, so I'll sustain the objection.

MR. OLSON: Your Honor, a couple of housekeeping matters.

THE COURT: Um-h'm.

MR. OLSON: I believe this with claim was filed in all five estates, not just the Diversified estate. I did indicate that it affected all debtors.

THE COURT: Oh, I wondered why --

MR. OLSON: When I prepare --

THE COURT: -- that was in there.

MR. OLSON: When I prepare the order, do you want me to just indicate that it's disallowed against all five or just Diversified? I mean --

(Colloquy not on the record.)

THE COURT: This motion was only brought in Diversified. I would hope they would withdraw their claim if they have no basis for any other funds.

MR. OLSON: Yeah.

MR. SCHWARTZER: I'll write them --

MR. OLSON: Well, I do believe we --

MR. SCHWARTZER: I'll write them a letter --

MS. CUNNINGHAM: We'd be happy to --

MR. SCHWARTZER: -- your Honor.

MS. CUNNINGHAM: We've already withdrawn our claim in First Trust Deed Fund, your Honor, and we'll be happy to withdraw our claims in the others.

THE COURT: Okay.

MR. OLSON: Okay. And your findings and facts --

THE COURT: Conclusions on the record, on the record.

MS. CUNNINGHAM: I mean --

MR. OLSON: Thank you.

MS. CUNNINGHAM: -- pending, of course, that my clients decide not to appeal. I mean, I just want to preserve the record. I'm not trying to be difficult.

THE COURT: All right. I understand that, but, I mean, you know, be careful. If you don't have a claim against these other funds, then now is the time to withdraw it before somebody does bring a 9011 action.

MS. CUNNINGHAM: Okay.

MR. OLSON: And just to be clear, the pleadings did indicate that it affected all debtors.

THE COURT: Right.

MR. OLSON: I had checked that box off.

THE COURT: Oh, you did. Okay. All right. So I'll sustain your objection in all five cases, then.

MR. OLSON: Thank you.

THE COURT: Okay. Thank you.

THE CLERK: All rise.

(Court concluded at 01:35:19 p.m.)

I certify that the foregoing is a correct transcript from the electronic sound recording of the proceedings in the above-entitled matter.

/s/ Lisa L. Cline 11/30/06

Lisa L. Cline, Transcriptionist Date